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In the Supreme Court of the United States

OCTOBER TERM, 1936

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

H. C. GOWRAN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit entered in the above entitled cause on December 22, 1936, reversing a decision of the Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 39) is reported in 32 B. T. A. 820. The opinion of the Circuit Court of Appeals is reported in 87 F. (2d) 125.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 22, 1936. A petition for rehearing was denied January 12, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether a dividend by a corporation in its own preferred stock payable to holders of common, resulting in the alteration of the preexisting proportionate interests of the stockholders in the two classes of stock, constitutes taxable income to the taxpayer under Section 115 of the Revenue Act of 1928.

2. Assuming that such a dividend does not constitute taxable income at the time of its receipt, what is the correct cost basis of the dividend stock?

3. In the event that this Court should hold that the stock dividend in question was not taxable at the time of its receipt and that the cost basis of the dividend stock under the circumstances is not zero, the further question is presented whether the case should be remanded to the Board of Tax Appeals for a determination with respect to the application of Section 115 (g) dealing with the redemption of stock under such circumstances that it should be treated as equivalent to the distribution of a taxable dividend.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 15–18.

STATEMENT

The facts, as found by the Board [1] (R. 41–43), are substantially as follows:

H. C. Gowran, the taxpayer and respondent herein, resides at Two Rivers, Wisconsin (R. 41).

Hamilton Manufacturing Company, hereinafter referred to as the company, was incorporated on February 23, 1926, under the laws of Wisconsin. Article III of its "Articles of Organization" as amended on April 5, 1926, and on December 27, 1928, provides that the company's capital stock shall be divided into 10,000 shares of preferred stock of the par value of $100 each, entitled to a preferential cumulative dividend at the rate of 7 per cent per annum, payable out of net profits; and 30,000 shares of common stock without nominal or par value. Article III further provides that the holders of common stock shall have certain rights and powers, including voting rights, and that the company shall have the right to purchase and redeem any part or all of the preferred stock on the first of January or July in any year, by paying $105 for each share, together with accrued dividends,

[1] As distinguished from the report of a division of the Board. (R. 18.)

and that the preferred stock when so redeemed and canceled, may be reissued. (R. 41–42.)

On July 1, 1929, the company's common capital stock, issued and outstanding, amounted to 18,680.8 shares held by 30 individuals in amounts ranging from 1 share to 6,189 shares. Prior to that date its preferred stock, issued and outstanding, amounted to 7,155 shares held by approximately 300 individual stockholders. The taxpayer and the other petitioners before the Board held no shares of the company's preferred capital stock prior to July 1, 1929. On July 1, 1929, the company's earned surplus available for distribution was not less than $444,147.05. (R. 42.)

On June 29, 1929, the company's board of directors, at a special meeting, adopted a resolution which, after setting forth that the company's surplus was in excess of $261,531.20, the total of a $14 per share dividend on 18,680.8 common shares outstanding, and that there remained unissued $261,600 par value preferred stock available for issue by way of stock dividend, provided in part as follows (R. 42):

> Resolved, by the Board of Directors of Hamilton Mfg. Company, that there be and there hereby is declared a dividend on all of the outstanding common capital stock of the company, to the holders thereof of record on July 1, 1929, amounting to $14.00 per share, and that the officers of the company be and they hereby are directed to pay

> and distribute said dividend forthwith to said stockholders of record, pro rata to each in proportion to his present holdings of common stock, in the form of certificates of the company's preferred stock, each share of said preferred stock so distributed to be taken at its par value, viz: $100.

Pursuant to this resolution the taxpayer, who owned 3,812.25 shares of common stock, received 533.715 shares of preferred (R. 42). The preferred stock so received by the taxpayer on July 1, 1929, had a fair market value of $100 per share on that date (R. 43).

Subsequent to September, 1929, the taxpayer agreed to sell to the company at par all the preferred stock issued to him as a dividend, and on or about October 1, 1929, the company purchased at par all such preferred stock, for resale to its employees (R. 43).

The case was originally heard by a division of the Board of Tax Appeals on the question whether the redemption of the stock previously declared as a dividend in the same taxable year was essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928. While the division, consisting of a single member, had the case under consideration, the Board decided *Tillotson Mfg. Co.* v. *Commissioner* (27 B. T. A. 913, affirmed, 76 F. (2d) 189 (C. C. A. 6th)), in which it held that a dividend upon preferred shares payable in common was not

a tax-free stock dividend under Section 201 (f) of the Revenue Act of 1926. The Commissioner filed a motion for reconsideration in the instant case because of that decision, and the motion ultimately was granted. (R. 36–37.) The case was assigned to another division and subsequently reviewed by the Board, which held (two members dissenting) that the stock dividend in question was subject to tax at the time of its receipt under Section 115 (f) of the Revenue Act of 1928 (R. 45), and that accordingly it was not necessary to pass upon the question whether the redemption of the stock previously declared as a dividend in the same taxable year was essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928 (R. 41).

The taxpayer appealed to the court below, which decided that the stock dividend in question, while constituting income under the Sixteenth Amendment, was not subject to tax under Section 115 (f) of the Revenue Act of 1928. With respect to the cost basis of the dividend stock, the court decided that it was the value of the stock at the time the taxpayer received the stock dividend, and overruled the Government's contention that the dividend stock had no cost basis because the stock cost the taxpayer nothing. As to the Government's alternative argument, under Section 115 (g) that the redemption of the stock was essentially equivalent to a taxable dividend, the court adopted the

original report of a division of the Board, although the case was afterwards reviewed by the entire Board, which expressly refrained from passing upon that question on the ground that its decision on the construction of Section 115 (f) rendered it unnecessary.

On January 11, 1937, the Government filed a petition for rehearing principally on the ground that the lower court erroneously gave effect to the report of a division of the Board after the case had been reviewed by the full Board, which apparently conflicted with the terms of Section 601 of the Revenue Act of 1928 providing that the report of a division shall not be a part of the record in any case in which the chairman directs that such report shall be reviewed by the Board. The lower court denied the petition for rehearing on January 12, 1937.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the stock dividend in question was not subject to tax at the time of its receipt under Section 115 (f) of the Revenue Act of 1928 although it represented income under the Sixteenth Amendment.

2. In failing to hold that Section 115 (f) applies only to stock dividends that do not constitute income under the Sixteenth Amendment.

3. In holding that the cost basis of stock previously issued as a stock dividend, which was

exempt under Section 115 (f) at the time of receipt, is the value of the stock at the time it was received by the stockholder.

4. In holding that Section 115 (f) was intended to exempt the value of stock dividends from tax at the time they were sold as well as at the time of receipt.

5. In failing to hold that the cost basis of stock previously issued as a dividend, which might have been taxed as income under the Sixteenth Amendment at the time of receipt, is nothing because it cost the taxpayer nothing.

6. In refusing to remand the case to the Board of Tax Appeals for a determination with respect to the application of Section 115 (g) to the circumstances of this case.

7. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. Whether the term "stock dividend" in Section 115 (f) of the Revenue Act of 1928 was intended to mean any stock dividend or only a stock dividend that does not constitute income to the shareholder under the Sixteenth Amendment is an important question of Federal law which has not been, but should be settled by this Court. In *Koshland* v. *Helvering*, 298 U. S. 441, this Court decided that a stock dividend similar to that here involved constitutes taxable income under the Sixteenth Amendment. The *Koshland* decision overturned

long-established administrative practice and immediately the question arose whether subdivision (f), providing that a stock dividend shall not be subject to tax, should apply to stock dividends that represent income under the Sixteenth Amendment. In the *Koshland* case this Court left this question open and said that it was not necessary to decide for the purposes of that case whether Congress intended to exempt stock dividends that constituted income under the Sixteenth Amendment at the time of their receipt. The question is now squarely presented in this case and in the case of *Helvering* v. *Pfeiffer,* decided February 15, 1937 (C. C. A. 2d), in which a petition for a writ of certiorari is also being filed.

The decision of the lower court with respect to the construction of Section 115 (f) is believed to be erroneous. The legislative history of the provision clearly shows that Congress originally intended to tax stock dividends and yielded only after the decision of this Court in *Eisner* v. *Macomber,* 252 U. S. 189. The Congressional Committee reports relating to subdivision (f) as first enacted show that Congress felt that it was "required" to enact such a provision by the decision of this Court in *Eisner* v. *Macomber, supra.* Congress intended to tax all dividends, subject only to the exception that if a dividend did not constitute income under the Sixteenth Amendment it was not to be taxed.

2. The reasoning upon which the court below reached the conclusion that the basis for determining gain or loss was the value of dividend stock when received cannot be reconciled with the reasoning of this Court in the *Koshland* case. In that case this Court held that where a taxpayer sold preferred stock on which she had previously received a dividend in common stock, the cost basis of the original (preferred stock) could not be reduced, as provided in the Treasury Regulations, by allocating the cost between the common and the preferred. This Court held that the statutory basis was "cost" and that the cost of the original stock was what the taxpayer paid for it. Here, too, the statutory basis is cost, and since adherence to cost was required in the *Koshland* case, it appears to follow that cost is the basis here. Since the dividend stock was acquired without any new investment, and since no part of the original investment can be allocated to it, it seems to follow that the basis for determining gain or loss of the dividend stock is zero.

The theory on which the lower court held that the basis of the dividend stock was its value at the time the taxpayer received it, is that a stock dividend is expressly tax-free under Section 115 (f), and therefore it should be treated like tax-free gifts, bequests or legacies. The basis for tax-free gifts, bequests and legacies is prescribed by the statute and by regulations of long standing to be value at date of acquisition. There is no similar

provision applying to stock dividends, and there is no authority in the Circuit Court of Appeals to prescribe a basis which departs from the statute. Moreover the analogy between tax-free gifts, bequests and devises, on the one hand and stock dividends, on the other, is not apt because the reason for adopting the value at the time of acquisition as the basis for tax-free gifts, bequests and legacies is not present here. The specific exemption of the value of gifts, bequests and legacies would not be preserved unless the recipient were permitted to recover tax-free the value at the time of acquisition. Furthermore, the value of the gift is subject to a gift tax and the value of bequests and legacies is subject to an estate tax so that the value would be taxed twice, unless the basis for determining gain or loss were fixed as value at the time of acquisition. While double taxation is not invalid, it is clear that Congress did not intend to impose it in the case of gifts, bequests and legacies.

In dealing with stock dividends, as distinguished from gifts, bequests and devises, Congress has evinced no purpose to do more than required by the decision of this Court in *Eisner* v. *Macomber, supra.* Even should this Court hold that the statutory exemption applies to all stock dividends, it is clear that the exemption was not prompted by any purpose to exempt the value of such stock dividends but, on the contrary, that Congress desired to tax them if possible. If they are not taxable on

receipt and their value at that time is not taxable upon disposition, it is clear that complete immunity from taxation has been accomplished despite the purpose of Congress to tax them if possible. Thus, instead of relief from double taxation, as in the case of gifts, bequests and legacies, the adoption of value at the time of receipt as the basis for stock dividends will result in a complete exemption from tax.

3. The case should be remanded to the Board of Tax Appeals for a determination with respect to the application of Section 115 (g) of the Revenue Act of 1928, *infra*, p. 16, to the circumstances of this case. Section 115 (g) provides that if the redemption of stock is done at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend, the distribution should be treated as a taxable dividend. The lower court gave effect to the report of a division of the Board in regard to the application of Section 115 (g), although the case was later reviewed by the full Board. Under the terms of Section 601 of the Revenue Act of 1928, *infra*, p. 17, amending Section 906 (b) of the Revenue Act of 1924, the report of a division shall not be a part of the record in any case in which the chairman directs that such report shall be reviewed by the Board. It was clearly erroneous for the lower court to give effect to the report of the division of the Board under the terms of Section 601 of the Revenue Act of 1928.

4. The Bureau of Internal Revenue advises that there are now pending before the Board of Tax Appeals seventeen cases involving approximately $3,000,000 in taxes, in which either the question of whether a stock dividend representing income under the Sixteenth Amendment is exempt at the time of its receipt or the question of cost basis of such stock when it is sold, is presented. Both questions are involved in the instant case inasmuch as the taxpayer sold the dividend stock during the same taxable year. None of the seventeen cases before the Board has so far been tried, so that it is not likely that a conflict of decisions of Circuit Courts of Appeals could arise within two or three years.

The Bureau of Internal Revenue also advises that there are pending in the Income Tax Unit cases for 1933, 1934 and 1935 in which several large corporations paid stock dividends in one class of stock to holders of another class aggregating about $28,000,000. It is impossible at this time to ascertain the amount of taxes involved, but it would probably amount to several million dollars. There are probably some small or closely held companies which have paid similar stock dividends on which no practical check can be made. Moreover the question of cost basis of dividend stock may arise in any case in which a taxpayer disposes of stock previously received as a dividend on another class of stock within the past twenty-four years. It is im-

possible to estimate the amount of tax involved in such cases, but it will probably be large.

CONCLUSION

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Seventh Circuit should be granted.

STANLEY REED,
Solicitor General.

APRIL, 1937.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to

the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(f) *Stock dividends.*—A stock dividend shall not be subject to tax.

(g) *Redemption of stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend. In the case of the cancellation or redemption of stock not issued as a stock dividend this subsection shall apply only if the cancellation or redemption is made after January 1, 1926.

(h) *Definition of partial liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

SEC. 601. BOARD OF TAX APPEALS—PROCEDURE.

Sections 906 and 907 (a) and (b) of the Revenue Act of 1924, as amended, are further amended to read as follows:

"SEC. 906. (a) The chairman may from time to time divide the Board into divisions of one or more members, assign the members of the Board thereto, and in case of a division of more than one member, designate the chief thereof. If a division, as a result of a vacancy or the absence or inability of a member assigned thereto to serve thereon, is composed of less than the number of members designated for the division, the chairman may assign other members to the division or direct the division to proceed with the transaction of business without awaiting any additional assignment of members thereto. A division shall hear, and make a determination upon, any proceeding instituted before the Board and any motion in connection therewith, assigned to such division by the chairman, and shall make a report of any such determination which constitutes its final disposition of the proceeding.

"(b) The report of the division shall become the report of the Board within 30 days after such report by the division, unless within such period the chairman has directed that such report shall be reviewed by the Board. Any preliminary action by a division which does not form the basis for the entry of the final decision shall not be subject to review by the Board except in accordance with such rules as the Board may prescribe. The report of a division shall not be a part of the record in any case in which

the chairman directs that such report shall be reviewed by the Board.

* * * * * *

Treasury Regulations 74, relating to the Revenue Act of 1928:

ART. 628. *Stock dividends.*—The issuance of its own stock by a corporation as a dividend to its shareholders does not result in taxable income to such shareholders, but gain may be derived or loss sustained by the shareholders from the sale of such stock. The amount of gain derived or loss sustained from the sale of such stock, or from the sale of the stock in respect of which it is issued, shall be determined as provided in articles 561 and 600.

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